Internal Revenue Service
memorandum

CC:TL
Br3:FJElward

date: AUG 31 1989

to: District Counsel, Albuquerque SW:ABQ

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [redacted]

Tax Litigation Advice

Your memorandum of June 23, 1989 requested Tax Litigation Advice on an issue presented in the above case.

ISSUE

Whether the petitioner can deduct in [redacted] the entire liability which it incurred as a guarantor of the debts of a related corporation even though it had not paid any money on the guarantee until [redacted] and had resisted payment until it reached an agreement with the creditors of the original debtor under which it bound itself to pay the creditors and the suits on the guarantee were dismissed.

FACTS

The following statement of facts is summarized from your memorandum.

The petitioner, [redacted], is an accrual basis taxpayer. The petitioner, on [redacted], held [redacted] % of the stock in a corporation named [redacted] ([redacted].

[redacted], which was in the refining business, on [redacted], agreed with [redacted] to purchase refining equipment from [redacted]. Under the agreement, the equipment was to be dismantled and removed by [redacted] from [redacted]'s site at [redacted]'s expense. To finance the removal of the equipment, [redacted] borrowed $[redacted] from the [redacted]. The petitioner guaranteed both the payments due [redacted] and the bank.

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In [redacted], [redacted] ceased operations and defaulted on the above contracts. Both [redacted] and the bank filed suit against petitioner on the guarantees. In [redacted] petitioner settled the litigation by separate agreements. Under an agreement with [redacted], petitioner agreed to pay $[redacted] and under the agreement with the bank it agreed to pay $[redacted] in $[redacted] monthly installments over [redacted] years with interest at [redacted]%. Pursuant to the agreements petitioner paid a total of $[redacted] in [redacted], composed of a payment of $[redacted] to [redacted] and $[redacted] to the bank. (There appears to be a discrepancy between what was paid to the bank in [redacted] and the terms of the agreement with the bank, as summarized in your memorandum. Since it is not significant to the resolution of the issue presented in this Tax Litigation Advice, we have not attempted to resolve it.)

Petitioner claimed a deduction for bad debts on its [redacted] return of $[redacted], consisting of the total it agreed to pay to the bank and [redacted] under the [redacted] settlement. The Service denied any deduction for bad debts in [redacted] as result of the guarantees. The Service proposed to allow petitioner to deduct as bad debts the amounts it actually paid under the [redacted] agreements in the years of payment.

The Service's disallowance of the claimed bad debt deduction for [redacted] is based on its reading of Treasury Regulation § 1.166-9, which states that a taxpayer's obligation as a guarantor, endorser, or indemnitor is treated as a worthless nonbusiness debt in the taxable year in which the payment is made.

The petitioner argued the deduction should be allowed in [redacted] since it is an accrual basis taxpayer and for accrual basis taxpayers the term payment in the above regulation must be read as accrual.

CONCLUSION

Your memorandum agrees with the position taken by the Service administratively. In your view, the fact that the petitioner is an accrual basis taxpayer does not change the result as dictated by a literal reading of Treasury Regulation § 1.166-9 since the petitioner did not sustain a worthless debt loss until it paid a sum under the guarantee and was unable to obtain reimbursement from [redacted]. We agree.

We referred your memorandum to Branch No 1 of this Division since it has jurisdiction over accounting questions-we have no doubt that absent some overriding principal of accounting to the contrary, the cited Treasury regulation requires payment before any amount of a liability under a guarantee can be deducted as a bad debt. For the reasons stated in the attached memorandum,

dated [redacted], we agree that the petitioner is not entitled to any deduction in [redacted] as a result of its guarantee of [redacted]'s obligations to [redacted] and the bank.

There are a number of defenses to petitioner's theory. In sum, the Treasury Regulation is to be read literally since even an accrual basis taxpayer does not sustain a bad debt loss until it makes a payment under the guarantee and becomes a creditor of the original debtor by subrogation but receives a worthless obligation in return for its payment. Even under the rules of accrual, the deduction would not be allowed in [redacted], since under the "all events" test, neither the certainty of liability nor the amount of liability had become fixed as the petitioner was resisting liability under the guarantee at the close of [redacted] and had not transferred any amount of money in that year to provide for the satisfaction of its liability under the guarantees.

MARLENE GROSS

By: _____
SOMMERS T. BROWN
Acting Chief, Branch No. 3
Tax Litigation Division

Attachment
Memorandum of 8/14/89.